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WASHINGTON, DC 20224

UILC No.:
280A.06-00

CC:ITA:2:MEBrookens
COR-117177-00

March 19, 2001

MEMORANDUM FOR MR. MICHAEL PERLMUTTER
LEAD CUSTOMER SERVICE REPRESENTATIVE
ACCOUNTS MANAGEMENT DIVISION III, GROUP 6140
JACKSONVILLE, FL

FROM: Heather C. Maloy
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SUBJECT: Section 280A(c)(6)

This technical assistance memorandum responds to your inquiry concerning the effect of § 280A(c)(6) of the Internal Revenue Code on the deductibility by an individual taxpayer of expenses attributable to the rental of a portion of a dwelling unit to his employer. The employer is an S corporation of which the employee is the sole shareholder and sole employee. During the period of the rental the individual used the rented portion in performing services as an employee. The individual also used the dwelling unit as a principal residence. Our discussion supplements previous oral advice we have given you on this subject.

Your inquiry was prompted by an individual described above who was concerned because he could not find a place on the applicable forms to claim certain business expenses and depreciation attributable to the rental income. You asked for guidance concerning the appropriate form(s) to use in reporting the rental income and deductions.

Please note that technical assistance does not relate to a specific case and is not binding on audit or appeals offices. This document may not be cited as precedent.

ISSUE:

How should an individual who rents a portion of his dwelling unit to his employer and who uses the dwelling unit in performing services as an employee of that employer treat the expenses attributable to the rental of the dwelling unit?

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CONCLUSION:

The individual described above may deduct home mortgage interest, real property taxes, and personal casualty losses to the extent permitted by §§ 163, 164, and 165(c)(3) and (h). However, the individual may not deduct otherwise allowable trade or business expenses under § 162, business casualty losses under § 165(c)(1), or depreciation under § 167, to the extent those expenses and losses are attributable to the use by the employee of the dwelling unit in performing services for the employer.

OVERVIEW:

In general, § 280A applies to individuals who use their homes both for personal purposes and for the production of trade or business income. The section is designed both to insure that the business use of the home does not result in an inappropriate conversion of nondeductible personal, living, and family expenses into deductible expenses and to permit the deduction of legitimate business expenses incurred in using the home to earn income.

Section 280A(a) generally disallows otherwise allowable deductions with respect to the business use of an individual's residence. However, § 280A(b) provides an exception to that disallowance rule by providing that § 280A(a) "shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity)." In other words, § 280A(b) provides that if an individual who uses his home entirely for personal purposes could take a deduction related to that personal use, he may also take the deduction if he uses the home both for personal purposes and to carry on trade or business activities. Thus, § 280A(a) and (b), taken together, permit an individual who pays home mortgage interest expense and state and local real property taxes to deduct those payments -- if the rules found in §§ 163(h) and 164(a)(1) are met -- regardless of whether that individual uses his residence solely for personal purposes or for both personal and business purposes.¹

Deductions for the business use of a home are potentially available only if the use falls into one of the four categories listed in § 280A(c)(1) - (4). Those categories are, respectively, specified home office uses (§ 280A(c)(1)(A), (B), and (C)), storage of inventory or product samples in the home (§ 280A(c)(2)), rental of the property

¹ However, although the aggregate amount of deductible home mortgage interest, real property taxes, and personal casualty losses is not affected by partial business use of the home, those deductions must be allocated between business and personal use of the home to prevent circumvention of the gross income limitation (or deduction limit) of § 280A(c)(5).

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(§ 280A(c)(3)), and use of the home in providing day-care services (§ 280A(c)(4)). In general, the business expenses associated with those uses are deductible only if the individual's business use of the home is regular (rather than occasional or incidental), and only to the extent the income earned from the business use of the home equals or exceeds the business expenses. Section 280A further requires both that expenses be reasonably allocated between business and personal use and that expenses be taken in a specified order. In addition to these general rules, particular rules apply to some of the business uses listed above. Publication 587, Business Use of Your Home (2000) contains a detailed description of the various § 280A rules.

DISCUSSION:

Your questions involve a corporate employee whose receipt of business income and whose incurring of business expenses relate to three of the § 280A(c) business uses listed above: the (c)(1)(A) and (B) home office use and the (c)(3) rental use. For ease of discussion, we will refer to two hypothetical employees – E-1 and E-2 – both of whom use part of their homes (but not a separate structure detached from the dwelling unit) in performing services for their employers and both of whom are the sole shareholders of their S corporations. Assume the following additional facts concerning these hypothetical employees:

(1) E-1 receives a reasonable salary from her employer (includible in her gross income under § 61(a)(1)) and seeks to claim a home office deduction.

(2) E-2 receives a reasonable rent from his employer (includible in his gross income under § 61(a)(4)) and seeks to deduct business expenses related to that rental.

To claim a home office deduction, E-1 must satisfy both the general requirements of § 280A and the particular requirements of § 280A(c)(1)(A) or (c)(1)(B). Specifically, under § 280A(c)(1), E-1 must show that she used her home office exclusively and regularly either as (A) her principal place of business in her trade or business of being an employee, or as (B) a place of business in which she meets or deals with patients, clients, or customers in the normal course of her business. In addition, E-1 must show that her exclusive use of the home office is for the convenience of her employer.

Assuming E-1 can meet the general and specific rules of § 280A, she should calculate her home office expense deduction by using the worksheet contained in Pub. 587. Such expenses are generally claimed on various lines of Schedule A, Form 1040 (2000). Pages 16 - 17 of Pub. 587 (2000) contain an example of how the expenses are calculated and reported and provide information about additional forms which E-1 may be required in some circumstances to prepare and file.

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However, because E-2 is receiving rental rather than salary income from his employer, E-2 will not be allowed to deduct business expenses attributable to the rental income. This result comes about not because it is more difficult to satisfy the rental use tests than the home office use tests -- indeed, ordinarily the opposite is true² -- but because of the particular disallowance rule of § 280A(c)(6).

Section 280A(c)(6) was added to the Code in 1986 by § 143(b) of P.L. 99-514, 100 Stat. 2120, 1986-3 C.B. (Vol. 1) 37. Section 280A(c)(6) provides that:

Treatment of rental to employer. Paragraphs [c](1) and [c](3) shall not apply to any item which is attributable to the rental of the dwelling unit (or any portion thereof) by the taxpayer to his employer during any period in which the taxpayer uses the dwelling unit (or portion) in performing services as an employee of the employer.

E-2 falls squarely within § 280A(c)(6), because E-2 is both renting to his employer (Y Co.) and using the rented portion of his dwelling unit to perform services as an Y Co. employee. Accordingly, § 280A(c)(6) will bar E-2 from deducting otherwise allowable § 162 trade or business expenses, § 165(c)(1) business casualty losses, and § 167 depreciation. That statutory bar, in turn, explains why there is no place on the forms to deduct those expenses.

Congress added § 280A(c)(6) expressly to overturn the Tax Court's decision in Feldman v. Commissioner, 84 T.C. 1 (1985), aff'd, 791 F.2d 781 (9th Cir. 1986). The taxpayer in Feldman, an employee, shareholder, and managing director of an accounting firm, not only had an office at the firm, but received an above-market rental payment from the firm to maintain an office (and related garage space) in his home. Because his home office did not meet the requirements of § 280A(c)(1), the taxpayer could not have claimed business expenses relating to its use. Despite the government's argument that the "lease" agreement in fact represented disguised compensation, however, the courts permitted the taxpayer to claim offsetting rental expenses under § 280A(c)(3).

In enacting § 280A(c)(6), Congress observed that the Tax Court's interpretation of § 280A in Feldman could lead to the circumvention of statutory restrictions on the deduction of home office expenses. In particular, Congress was concerned that: (1) employers and employees could arrange sham transactions (whereby a portion of salary was paid in the form of rent), and (2) the employer-employee transactions would

² The § 280A(c)(3) rental use rules are usually easier for an individual to satisfy than are the (c)(1) home office use rules, because the (c)(3) rules do not contain the requirement of exclusive use found in the (c)(1) rules.

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not be negotiated at arm's length but would provide added tax deductions for the employee at no additional cost to the employer. Accordingly, Congress provided that no home office deductions were allowable (other than expenses such as home mortgage interest and real estate taxes that are deductible absent business use) if the employee rents a portion of his or her home to the employer. H.R. No. 99-426, 1986-3 C.B. (Vol. 2) 133.

It should be noted, however, that although § 280A applies to S corporations as well as to individuals, the only taxpayer to whom § 280A(c)(6) refers is the employee. Thus, for example, an S corporation's deduction under § 162 for rent is not affected by § 280A(c)(6).

We hope this memorandum is helpful. If you have further questions, please contact Ms. Marilyn E. Brookens at (202) 622-4920.